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THE LIEN THEORY OF THE MORTGAGE—TWO CRUCIAL PROBLEMS.

IN a recent article in this review¹ the writer discussed in a general way the nature of a mortgage of real property in the states which adopt the lien or equitable theory of the mortgage. The conclusion therein arrived at was that, while the mortgage does not convey the legal title to the land until foreclosure, it does convey to the mortgagee, at the time of its execution, a present interest in the land, the general ownership of which remains in the mortgagor—an interest which is limited and special, more analogous to an easement than to general ownership; which is contingent or inchoate, in that default and foreclosure are essential to its ultimate enjoyment; and which is merely collateral to a principal right to receive something of value: but which is a legal interest as distinguished from an equitable interest; a right *in rem* as distinguished from a right *in personam*; a right which, in the terminology of jurisprudence, would be called an "hypothecation."² This conclusion was arrived at by a course of deductive reasoning. The premises were found in our case law but the conclusion was so remote from the premises that it lacked a convincing foundation of authority. In the present article we will examine two specific problems in mortgage law which offer a test of this conclusion. The discussion will be chiefly confined to the specific problems in hand but the primary purpose will be to get at the underlying theory of the mortgage.

The chief practical difference between a legal interest in land and a merely equitable interest lies in the application of the equitable doctrine of bona fide purchase, by which the bona fide purchase of a legal interest is a complete defense to the assertion of a prior equitable interest, while between conflicting interests both of which are legal or both of which are equitable the one which is prior in time is preferred. For a test of the question in hand we would, therefore, naturally turn to the case of a mortgage of land followed by a bona fide purchase of the legal title from the mortgagor and the case of the creation of an equitable interest followed by a mortgage by the owner of the legal title to a bona fide mortgagee. Cases of this sort, however, are almost invariably controlled by the record-

¹ Vol. 10, pp. 587-607 (June, 1912).

² For a definition of this term and an analysis of the various rights which one may have in land, see Holland, *Jurisprudence* (10th Ed.) pp. 183-225.

ing acts, which make no distinction between legal and equitable interests, either as to the prior conveyances, on the one hand, which they avoid or postpone, if not recorded, and give constructive notice of, if recorded, or as to the subsequent purchaser, on the other hand, whom they prefer or charge with constructive notice, as the case may be.³ To test the theory in question, then, we must eliminate the recording acts, and the problems hereinafter discussed are selected as involving questions of priority between a mortgagee and a subsequent bona fide purchaser, on the other hand, or a prior equitable claimant, on the other, which are not controlled by those statutes.

The first of these problems is this: given a mortgage of land operating under the lien theory and a subsequent absolute conveyance by the mortgagor, or one deriving title from the mortgagor, to one who gives value and has no notice of the mortgage, neither the mortgage nor the conveyance being recorded, or the mortgage being recorded after the execution of the conveyance but before the recording of the conveyance; and given a recording act of the common form requiring certain conveyances to be recorded and providing that an unrecorded conveyance "shall be void as against a subsequent purchaser in good faith * * * *whose conveyance shall first be duly recorded*;" which party his priority?

The recording act is wholly inoperative in this case. It does not avoid the mortgage in favor of the purchaser because the latter's conveyance is not "first duly recorded." The purchaser satisfies the first requirement of the statute, as being a "subsequent purchaser in good faith," but he fails to satisfy the second requirement of the statute, which is conjunctive with the first. The only doubt which can be thrown on this position is engendered by approaching the question from the point of view of constructive notice and insisting that the purchaser does not have constructive notice of the mortgage from the record and therefore takes free from the mortgage. This line of reasoning, supported by dicta of the court, led to a decision in *Fallas v. Pierce*, 30 Wis. 443, (1872), that on the facts of our problem the purchaser would prevail. This decision was affirmed on rehearing (Ib. 450) but on a second rehearing it was reversed and the mortgagee allowed to foreclose (Ib. 454-482). DIXON J., in delivering the final opinion in the case, says, "This * * * condition ('whose conveyance shall first be duly recorded') * * * must be complied with by the subsequent purchaser in good faith and for a valuable consideration, before he can claim

³ Jones, Mortgages, § 476; 13 L. R. A. 236, note.

the benefit and protection of the statute. Without the deed to such a subsequent purchaser *first upon record*, the title under the prior unregistered deed must still be preferred. * * * Much confusion and uncertainty have been brought into the treatment and discussions of this subject, by the frequent and almost continuous use and recurrence in the opinions of courts and the works of authors, of the words 'constructive notice.' Those words are not anywhere found in the registry laws, and, although their meaning is in general well understood, yet they are often so employed as to confuse and perplex the reader, rather than to convey an intelligent idea of the precise view which the court takes of the statute or of the principle or reason which lies at the foundation of the decision. * * * In respect to the deed first executed, and first recorded, the registry law does not break in upon or conflict, but is in entire harmony with the rule of the common law, that he who is first in time is first in right; that an owner, who has once conveyed his estate or title, cannot afterwards convey the same estate or title by the execution of a subsequent deed to another. Independently of the recording act, the prior deed, though unrecorded, has full operation and effect, that is to say, defeats a subsequent purchase and deed, however truly made, in good faith and without notice."

The same result, so far as concerns the construction of the statute, has been arrived at in other states having this statute without the difficulty encountered in Wisconsin and therefore, of course, without the fullness of explanation found in the foregoing case.⁴

To these authorities, which show that upon the facts of our problem the *purchaser* cannot claim any benefit under the recording acts, we may add that neither can the *mortgagee* derive any advantage therefrom. On the first of the two alternatives included in the problem, that of neither conveyance being recorded, this is obvious. On the other alternative, that of the mortgage being recorded, after the subsequent conveyance is executed but before it is recorded, it is less obvious but equally true. The statute merely provides that unrecorded conveyances shall be void as against certain subsequent conveyances, and does not provide that recorded conveyances shall be superior to subsequent conveyances. It denies the advantage of the statute to subsequent purchasers whose conveyances are not first recorded, but does not say that all conveyances shall take rank in the order of recordation.⁵ It does not expressly abrogate the equit-

⁴ 24 Am. & Eng. Encyc. 140.

⁵ The statement that conveyances take rank in the order of their recordation is not uncommon in text and opinion. It is usually qualified by some such expression as "in general," but, whether so qualified or not, it must be taken as being but a con-

able doctrine of bona fide purchase and only does so by implication in those cases in which it substitutes a different rule of law. Here, again, the only doubt which can be thrown upon the question arises from a misapplication of the doctrine of constructive notice. To the literal import of the statute has been added, by judicial interpretation, the doctrine of constructive notice from the record, which amounts only to this, that a purchaser of land is charged with knowledge of all recorded conveyances in his chain of title, whether he actually has such knowledge or not—in other words that the record of such conveyances is equivalent to actual notice of them and is equally effectual in destroying bona fides. Constructive notice by the record is not more effective than actual notice for this purpose, and neither destroys bona fides if it comes after a purchase is completed by delivery of the conveyance and payment of the consideration.⁶ Aside from the doctrine of constructive notice, thus limited, a subsequent purchaser is not precluded by the recording acts from setting up any rights he may have against a prior conveyance under the equitable doctrine of bona fide purchase.

Our problem, then, being unaffected by the recording acts, the rights of the parties must be worked out under the rules of common law and equity. Under those rules, if the mortgagee's interest in the land is merely equitable it will be cut off by a bona fide purchase of the legal title, whereas, if it is a legal interest it will be unimpaired by such purchase.

In the case of *Ely v. Schofield*,⁷ decided by the Supreme Court of New York, General Term, in 1861, there was a mortgage executed on March 19, 1851, and recorded on March 21 of the same year; an assignment of the mortgage by the mortgagee's adminis-

venient formula which gives the correct result in the majority of cases. It does not appear to have been applied in any case where the difference between it and the terms of the recording act was material.

The result might be otherwise under such a statute as that in Ohio, which says, "Mortgages * * * shall take effect from the time the same are delivered * * * for record." Gen. Code, § 8542.

⁶ 23 Am. & Eng. Encyc. 522. Statutes of the form considered in the text add, to the requirement of bona fide purchase, the requirement of priority of record, but do not provide that the recording as well as the purchase must be bona fide, and no requirement of bona fide recording exists, either for the application of the recording acts (*Ely v. Schofield*, 35 Barb. 330), or, still less, for the application of the equitable doctrine of bona fide purchase, which the recording acts have not altered except in so far as they have substituted for certain cases a paramount rule of law. In short, the recording of the prior conveyance, after the subsequent conveyance is executed and the consideration paid, but before the subsequent conveyance is recorded, has a purely negative effect, viz., to prevent the subsequent purchaser from taking advantage of the recording acts.

⁷ 35 Barb. 330.

trator to the plaintiff, executed on March 2, 1855, but never recorded; a release of the mortgage by the administrator, executed April 9, 1858 and recorded May 4, 1858, which release was executed by mistake, without payment and without plaintiff's consent; and a conveyance, by one who had acquired the title of the mortgagor (subject it would seem to the plaintiff's rights), of part of the mortgaged land to the defendant, a bona fide purchaser, by a deed dated May 15, 1858, which was never recorded. The plaintiff filed a bill to foreclose the mortgage. The court held that the discharge of the mortgage had no other effect than to discharge the *record* of the mortgage leaving the plaintiff the holder of an unrecorded mortgage (a point which seems indisputable) and that the mortgage was superior to the defendant's title through his unrecorded deed, WELLES, J., who delivered the opinion, saying, "The parties stand upon equal grounds, as far as the record is concerned, and the statute only gives priority to a recorded conveyance; and the mortgage being anterior to the deed must prevail over it."

In the case of *Fallas v. Pierce*, *supra*, there was a mortgage of land duly recorded on March 28, 1859; an assignment of the mortgage executed on April 2, 1859, but not recorded until June 21, 1861; a release of the mortgage by the mortgagee on August 10, 1859, recorded on December 8, 1860, the mortgagor having knowledge of the assignment when he took the release; a conveyance by the mortgagor to the defendant, a bona fide purchaser, executed on September 19, 1860, but not recorded until January 10, 1868, after the recording of the assignment hereinbefore referred to. There was also an assignment from the first assignee to the complainant, executed and recorded after the recording of the release but before the recording of the defendant's conveyance, which, we assume, gave the complainant no greater rights than the first assignee had. The complainant filed a bill to foreclose. It having been determined that the defendant could derive no advantage from the recording acts (*ut supra*) the bill was sustained.

In the case of *Fleschner v. Sumpter*,⁸ decided by the Supreme Court of Oregon, there was a mortgage and a subsequent deed to a bona fide purchaser, both instruments being filed for record at the same time but the mortgage being properly acknowledged and entitled to record, while the deed was not. Foreclosure was decreed, the Court saying by THAYER, J., "The prior recording of the prior conveyance at any time after its execution will give it precedence." This and some other phrases of the opinion suggest that the prior-

⁸ 12 Ore. 161.

ity of the prior conveyance which is first recorded is derived from the statute. If the decision is regarded as resting solely on the operation of the recording acts it offers no authority on the problem before us but is merely an authority for an anomalous construction of the Oregon recording act. If the statement that "the prior recording of the prior conveyance * * * will give it precedence" is taken as meaning that prior recording will preserve the precedence which the prior conveyance already has, from any impeachment by the recording act, then the case is authority for the same proposition as the New York and Wisconsin cases referred to, though less explicit.

In none of these cases was the fundamental question now before us, that is, whether the mortgagee's interest was legal or equitable, discussed. But, bearing in mind that in the New York and Wisconsin cases the court distinctly recognized the entire inapplicability of the statutes and that in the Wisconsin case it explicitly stated that this left the prior conveyance in the position that it occupied by common law and equity, it is obvious that the question was squarely presented in these cases, and that the alternative of legal lien must have been assumed without debate.

These are the only cases of the sort which the writer has found.⁹ But there are a number of cases involving the same facts except for the subsequent purchaser being himself a mortgagee, which were decided in favor of the first mortgage.¹⁰ These cases might be reconciled with the theory that the lien of the mortgage is equitable, upon the principle that, both interests being equitable, the prior equity must prevail. They were not, however, decided upon that principle but upon the broad principle that the unrecorded mortgage will prevail over subsequent conveyances not first recorded, and in some of them the language of the court expressly includes subsequent *absolute* conveyances. It would seem unlikely that the courts would confine the authority of these cases to contests between mortgagees.

The second problem which we will examine is this: given an equitable interest in land, such as a constructive trust or a vendor's lien, which arises by operation of law, and a mortgage by the holder of the legal title to a bona fide mortgagee: will the mortgage be superior to such equity?

⁹ See, however, *Reasoner v. Edmundson*, 5 Ind. 393, in accord with the cases cited, discovered since the article went to press.

¹⁰ *Crouse v. Michell*, 130 Mich. 347; *Rumery v. Loy*, 61 Neb. 755; *Fort v. Burch*, 5 Denio 187; *Westbrook v. Gleason*, 79 N. Y. 23.

None of our recording acts affect this case, for they are all alike in requiring certain conveyances and instruments affecting title to be recorded, and providing that instruments not so recorded shall be avoided or postponed as to certain persons, with the addition, in some cases, of a provision that the recording of such instruments shall be constructive notice to certain persons. They do not provide that no interest in land shall be upheld against a bona fide purchaser unless evidence of it is recorded. They, therefore, leave untouched all interests in land which do not arise by a conveyance or instrument of the sort of which recording is prescribed by the statute.¹¹ A subsequent purchaser can only prevail over such interests by virtue of the equitable doctrine of bona fide purchase.

In *Parker v. Barnsville Savings Bank*,¹² decided by the Supreme Court of Georgia in 1899, plaintiff's husband bought land with funds belonging to her, taking title in his own name, and then executed a mortgage of the land to the defendant who had no notice of the plaintiff's rights. On a bill to enjoin the defendant from foreclosing and for other relief, it was held that the mortgage was superior to the plaintiff's equity. LITTLE, J., delivering the opinion of the Court, said, "Section 3934 of the Civil Code declares that 'A bona fide purchaser for value and without notice of an equity, will not be interfered with by a court of equity' * * * In a word, a bona fide purchaser without notice acquires an unqualified legal right and title to the property purchased, and a court of equity has no jurisdiction to interfere with such vested legal right and title. A mortgagee who in good faith parts with his money, in ignorance that a person other than the holder of the legal title has a secret equity in the mortgaged property, stands precisely in the attitude of a bona fide purchaser and is entitled to the same protection. * * * The bank then acquired a legal lien on the property, even though the mortgage may be infected with usury."

In the case of *Simpson v. Del Hoyo*,¹³ decided by the Court of

¹¹ See *McKamey v. Thorp*, 61 Tex. 648, disclosing a convincing line of cases to the effect that a judgment or attachment creditor, relying on the recording acts, cannot prevail over an equitable estate arising by operation of law, but that a bona fide purchaser, relying on equitable doctrines, will prevail. See also, *Hartsock v. Russell*, 52 Md. 619; *School Dist. v. Peterson*, 74 Minn. 122; *Floyd v. Harding*, 28 Gratt. 401. Note that the cases examined in the text ignore the recording acts and apply the equitable doctrine. See, however, *Riley v. Martinelli*, 97 Cal. 580, dictum contra.

Compare the following cases applying the same principle to a title acquired by adverse possession: *Faloon v. Simshauser*, 130 Ill. 649; *Schall v. Williams Valley R. R. Co.*, 35 Pa. St. 191; *McGregor v. Thompson*, 8 Tex. Civ. App. 32.

¹² 107 Ga. 650.

¹³ 94 N. Y. 189. The courts below decided against the assignee on the ground that he was an assignee of a non-negotiable chose in action and therefore stood in the shoe

Appeals of New York in 1883, the same principles were applied in favor of an assignee of a mortgage. A fraudulent grantee of land mortgaged it to one who had notice of the fraud, who in turn assigned the mortgage to a bona fide purchaser. In a suit by the assignee to foreclose, the court held the assignee superior to the rights of the defrauded vendor of the mortgagor. EARL, J., delivering the opinion of the Court, said, "It is a familiar rule of law that a fraudulent purchaser of real or personal property obtains the legal title to the property purchased, and that he may convey a good title to any *bona fide* purchaser from him for value. He may not only convey the property, but he may deal with it as owner, and may mortgage it; and whoever purchases the property or takes a mortgage thereon from him or under him, in good faith, for value, or deals with him in good faith in reference thereto will be protected against the claims of the defrauded vendor. The real estate may be conveyed, or a mortgage thereon may be assigned to several successive participants in the fraud, or several successive *mala fide* purchasers. But the moment the real estate or the mortgage reaches the hands of a *bona fide* purchaser for value, the rights and equities of the defrauded owner are cut off."

In *Fisk v. Potter*,¹⁴ decided by the same court in 1865, we find a peculiar application of the same principles. The plaintiff sold land on credit and conveyed it, by a deed not reserving a lien or disclosing that the price was not paid, to a railroad company, which had previously executed a mortgage of all its property, then owned or thereafter to be acquired, to trustees to secure an issue of bonds, neither the trustees nor the purchasers of the bonds having any notice of the grantor's rights until foreclosure was begun. The mortgage was thereafter foreclosed (the plaintiff not being made a party) and the land in question sold to the defendant, who had notice of the plaintiff's claim before he completed his purchase and who, therefore, depended for priority upon priority in the mortgagees. On a bill by the grantor to enforce a lien on the land it was held that the mortgage was superior to this lien. POTTER, J. delivering the opinion of the court, after disposing of a question of waiver adversely to the plaintiff, proceeded as follows: "But I am not willing to decide this case alone upon the ground I have been considering, as it was not the ground taken by the referee who decided the

of his assignor. The Court of Appeals held this principle inapplicable as between the assignee and a claimant of the land adverse to the mortgage. For a discussion of the dual nature of a mortgage as a chose in action, considered internally, and an interest in land, considered externally, see 10 Mich. L. Rev. 606-7.

¹⁴ 2 Keyes 64.

case; and, suppose I am in error in the view I have taken, then,—The legal title of the land in question, upon which plaintiff's conveyance was made to the railroad company, vested in the latter. At the same instant, the lien of the mortgage which had before that been given by the railroad company, and which, before that time, remained but an equitable claim upon '*rights to be acquired*,' according to the case of *Seymour v. The Canandaigua and Niagara Falls Railroad Company* (25 Barb. 308),¹⁵ became a vested *legal* right upon the premises in question. Assuming, now, for the purpose of the argument, the position urged by the plaintiff, that he did not intend to waive his equitable lien for the purchase-money, all he can then claim is, that his equitable lien attached at the same instant of time with the mortgage lien. * * * The learned referee assumes, in his decision, that both these liens were mere equitable ones. I think this was not so as regards the mortgage. This mortgage was executed in pursuance of an express provision of a statute of the State. It therefore became a legal mortgage, created for a legal purpose, and its lien must have been a legal lien upon all the premises it covered. * * * Upon the question of the superiority of liens, between such as are called *legal* and those which are called *equitable*, it is a maxim, coeval with the law of equity, that 'where equities are equal the law must prevail.' In Hargrave and Butler's notes to Coke upon Littleton, 290 b, the rule is thus laid down: 'If a person has the *legal* estate or interest in the subject-matter in contest, he must, necessarily, prevail at *law* over him whose right is only *equitable*, and not, therefore, even noticed by the courts of law. This advantage he carries with him so far, even into a court of *equity*, that, if the equitable claims of the parties are of equal force, equity will leave him who has the *legal* right in full possession of it, and will not do anything to reduce him to an equality to the other, who has the equitable right only.'

This decision would seem questionable. Granting that the lien of the mortgage is a legal lien, the mortgagees do not appear to have advanced their money upon the faith of this specific property, and, under these circumstances, they would not seem to satisfy the requirements of the equitable doctrine of bona fide purchase, as gen-

¹⁵ The case cited proceeds distinctly on the theory that, while in general, a mortgage of land to be acquired creates but an equitable lien on such land, when it is acquired, by reason of the rule of law that one cannot grant what he does not own, yet, in the case of a railroad company which has a franchise authorizing it to acquire the land necessary for its purposes and which mortgages its franchise, the after acquired land stands on the same footing at law as the land owned at the time of the mortgage and is subject to the lien of the mortgage.

erally understood and as stated in this very opinion, viz.: "*where equities are equal* the law must prevail."¹⁶ But, assuming that the decision is erroneous in respect to this point, this does not impeach it in respect to the point of the lien of the mortgage being a legal lien.

There are some other cases to the same effect,¹⁷ though lacking the explicit statement of principles contained in the cases above referred to. The writer has found no cases upon similar facts conflicting with the foregoing.

It is worth while to notice the practical effect of a doctrine contrary to that maintained by these cases. A mortgagee who succeeded in foreclosing before he received any notice of such "unwritten" equities would be unaffected by them, whereas, if he happened to receive such notice before foreclosure, he would be postponed to them. This would mean that prudence required a mortgagee to foreclose at the earliest possible moment and that any indulgence to the mortgagor, in the way of extension of time, would be at the hazard of his security—a rule of diligence which we believe would be a surprise to the most cautious counsellors and a result which could hardly have been contemplated by those courts and legislatures which interfered between mortgagor and mortgagee to modify the theory of the mortgage for the protection of the former.

In conclusion, and while we have before us these problems concerning the right of the mortgagee as against third persons to subject the land to the satisfaction of his debt, which bring us face to face with the ultimate and substantial nature of the mortgage, as distinguished from those incidental and technical questions, such as the manner and means of assigning and discharging the mortgage, or the right to possession and the maintenance of legal actions before foreclosure—while these problems concerning the very substance of the mortgage are before us, let us take a broad view of the fundamental question in hand. Bearing in mind that the lien of the mortgage ripens by foreclosure into a full legal title, and that this process does not require any act upon the part of the mortgagor, further than the execution of the mortgage and default in its payment, and bearing in mind that in this respect the foreclosure of a mortgage differs from the specific performance of a contract for the sale of land, which, in the absence of a statute conferring

¹⁶ See Jones, *Corporate Bonds and Mortgages*, § 117.

¹⁷ *Austin v. Pulschen*, 112 Cal. 528; *Gaar v. Milliken*, 68 Ind. 208; *Broward v. Hoeg*, 15 Fla. 372; *Watts v. Corner*, 8 Tex. Civ. App. 588; *Parsons v. Crocker*, 128 Ia. 641.

on the court jurisdiction *in rem* to execute a conveyance by its master or otherwise,¹⁸ requires the actual execution of a conveyance by the vendor, under compulsion if necessary; and bearing in mind, also, that, unlike the title acquired upon specific performance of a contract, which dates from the conveyance and not from the execution of the contract, the title acquired by foreclosure relates back to the execution of the mortgage so as to cut off intervening incumbrances¹⁹—bearing in mind these features of mortgage foreclosure, is it not manifest that, at the time of its execution, the mortgage raises a potentiality of legal ownership of the land, which, subject to all its limitations as a potentiality, must be a legal interest in the land. Can we, consistently with the theory of real property, conceive of a merely equitable or contractual interest in land ripening into a legal estate without the aid of a statute or a conveyance by the legal owner? It is submitted that we cannot.

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¹⁸ There is probably in all of the states more or less statutory authority for the common foreclosure and sale in equity but such authority is not essential. *Lansing v. Goelet*, 9 Cow. 346; *Byron v. May*, 2 Chand. (Wis.) 103; and see, *Benjamin v. Cavaroc*, 2 Woods 168; *Carroll v. Deimel*, 95 N. Y. 252; *Downing v. LeDu*, 82 Cal. 471, *Morrison v. Bean*, 15 Tex. 267. In at least one of the lien states the court has inherent jurisdiction to decree strict foreclosure (*Judd v. Hayward*, 4 Minn. 483; *Drew v. Smith*, 7 Minn. 301) by virtue of which the lien of the mortgage ripens into a legal title in the hands of the mortgagee without a sale.

¹⁹ See *Jones, Mortgages*, § 1654.

Note.—In the foregoing discussion the question has been considered as one of an alternative between legal lien and equitable lien. As noted in the writer's former article on this subject, there is some authority for a third position, viz., that the mortgage is merely a chose in action or contract and creates no interest in the land, legal or equitable. In this connection it should be observed that the foregoing authorities are inconsistent with this theory. The equitable doctrine of bona fide purchase requires not only legal rights but legal rights in rem. That doctrine is merely negative, that under certain circumstances the court will not interfere with legal rights but leave parties holding them to their full enjoyment, unimpaired by equity. To one who had, at law, no estate or interest in rem in the land, but merely a right against certain persons in respect thereto, such non-interference would be of no avail against third persons.